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APPLICATION OF

VIRGINIA-AMERICAN WATER COMPANY

CASE NO. PUE970523

For a general increase in rates

REPORT OF HOWARD P. ANDERSON, JR.

HEARING EXAMINER

July 30, 1999

By Order of December 22, 1998, the Commission remanded this case for reconsideration of Virginia-American Water Company's ("Virginia-American" or "Company") affiliate expenses. Virginia-American is a subsidiary of American Water Works Company, Inc. ("AWWC" or "Parent"). American Water Works Service Company ("Service Company") is also a subsidiary of AWWC and provides administrative, professional, and technical support to the Parent's water companies, including Virginia-American.

By Hearing Examiner's Ruling of January 28, 1999, a procedural schedule was established and a hearing was set for May 24, 1999, in this matter. At the hearing, Richard D. Gary and Michelle Walsh appeared as counsel for the Company, Edward L. Flippen appeared as counsel for the City of Hopewell, Louis R. Monacell appeared as counsel for the Hopewell Committee for Fair Utility Rates, and Marta B. Curtis appeared as counsel for Commission Staff.

SUMMARY OF THE HEARING RECORD

In support of its affiliate expenses, the Company presented the testimony of Patrick L. Baryenbruch,¹ president of Baryenbruch & Company, a public utility consulting firm. On behalf of the Company, Mr. Baryenbruch conducted a study² designed to answer two questions. First, what would be the economic impact on Virginia-American if it were to outsource all of the services it now receives from the Service Company? Second, are the services Virginia-American receives from the Service Company necessary? (Ex. No. PLB-34, at 2, 3).

¹Pursuant to prior agreement by counsel, Mr. Baryenbruch's study and testimony, as well as Staff's testimony, were admitted to the record without cross-examination. (Tr. 289).

²Mr. Baryenbruch conducted an identical study for Virginia-American's 1994 rate case, Case No. PUE950003. The methodologies and information sources are identical in both studies. Mr. Baryenbruch's current study is Exhibit A of Ex. No. PLB-34.

Based on his study, Mr. Baryenbruch reached the following conclusions:

1. The Service Company's hourly rates, on average, are 32% less than those of outside providers of similar services.
2. The services performed by the Service Company are vital and could not be procured externally by Virginia-American without careful oversight on the part of Virginia-American. If these services were contracted entirely to outside providers, Virginia-American would have to add at least one position to coordinate and oversee the activities of outside providers. This position would be essential to ensure a high level of quality service.
3. If all the services now provided by the Service Company were outsourced, Virginia-American and its ratepayers would incur an additional \$391,300 in annual expenses. This is 43% higher than the Service Company's total billings to Virginia-American during the year ended December 31, 1996.
4. It is doubtful that Virginia-American could find local service providers with the same specialized water industry expertise as that possessed by the Service Company staff. Service Company personnel have a level of expertise in water utility operations and regulation that is not readily available from outside service providers.
5. Service Company costs do not include any profit markup. Only the Company's actual cost of service is received from its ratepayers.

Mr. Baryenbruch further points out that Virginia-American pays less for purchases and services as a result of the Service Company's corporate-wide buying power. For instance, in 1998, stock materials would have cost Virginia-American \$200,000 more were it not for the national contract the Service Company negotiated on behalf of each of AWWC's subsidiary water companies.

Mr. Baryenbruch further supports the method in which Service Company costs that are not direct charges, are allocated to operating companies. These non-direct charge costs are allocated on the basis of number of customers. Mr. Baryenbruch characterizes this approach as straightforward and entirely appropriate in that it reasonably reflects how costs are incurred on behalf of the operating companies. Finally, Mr. Baryenbruch explains that the cost to administer this allocation technique is lower than more complicated alternatives that use multiple factors.

In conclusion, Mr. Baryenbruch made the following observations:

1. Virginia-American could not function without the services that are provided by the Service Company. The services provided by the Service Company to Virginia-American are necessary to provide water utility service to the Company's customers.
2. There is no redundancy in the services provided by the Service Company and the activities that are performed by Virginia-American.

The Commission Staff analyzed Mr. Baryenbruch's conclusions and found that the cost billed by the Service Company to Virginia-American is lower than the market price. Therefore, ratepayers should achieve savings through the Company's affiliate arrangement. Staff believes that, based on its analysis, it is reasonable to include the Company's affiliate expenses in rates. Based on the Commission's December 22, 1998 order and its analysis, Staff recommends the following gross annual revenue requirement:

Alexandria	\$171,912
Hopewell	\$329,596
Prince William	\$274,743

DISCUSSION

The Virginia Supreme Court in *Commonwealth Gas Services, Inc. v. Reynolds Metals Company*, 236 Va. 362 (1988), held that the burden is on the company to produce affirmative evidence of the reasonableness of affiliate charges. (*Id.* at 368). The Commission, in *Application of GTE South Incorporated*, Case No. PUC950019, 1997 S.C.C. Ann. Rep. 216, 218 (Final Order August 7, 1997) held that:

Where it is most economical for the utility to purchase the product or service from the market, it should do so. Where it can save money by purchasing from an affiliate at the affiliate's cost, including a reasonable return for the affiliate on the sale, it should do that. Where the Company proposes that the Commission set rates based on charges from an affiliate, the charges must be based on the affiliate's cost, including a reasonable return, so long as this cost does not exceed the market price. The market test applied by this Commission and the Court is to test whether the affiliate's costs are reasonable.

I find the Company's affiliate expenses are reasonable and should be approved. The Service Company bills Virginia-American at cost. The Company has provided cost comparisons of services received from the Service Company to services available from other vendors. Staff's analysis of these comparisons indicates the cost billed to Virginia-American is lower than the market price and ratepayers should achieve savings through the Company's affiliate arrangement. As noted above, the Commission has determined a reasonable return to the affiliate providing the goods or services is permissible. In this case, not only is Virginia-American receiving goods and services from the Service Company at cost, the Service Company is not charging any return on its services to Virginia-American.

FINDINGS AND RECOMMENDATIONS

Upon consideration of the evidence in this case, I find that:

- (1) The twelve months ending December 31, 1996, is an appropriate test period for the case;

- (2) The Company's test year operating revenues, after all adjustments, were \$25,236,174;
- (3) The Company's test year operating revenue deductions, after all adjustments, were \$20,208,911;
- (4) The Company's test year operating income and adjusted net operating income, after all adjustments, were \$5,027,263 and \$5,019,936;
- (5) The Company's affiliate expenses should be included in the Company's rates;
- (6) The Company's end of test period rate base, after all adjustments, is \$58,900,613;
- (7) The Company requires additional gross annual revenues of \$776,251;
- (8) The \$776,251 rate increase should be allocated as follows: Alexandria - \$171,912; Hopewell - \$329,596; and Prince William - \$274,743; and
- (9) The Company should be required to promptly refund, with interest, all revenues collected, but not already refunded, under its interim rates, effective November 3, 1997, in excess of the amount found just and reasonable herein.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P. O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all other counsel of record and to any party not represented by counsel.

Respectfully submitted,

Howard P. Anderson, Jr.
Hearing Examiner